POLICY BACKGROUNDER No. 152
For people with limited time and a need to know.

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Why the Social Security Earnings Penalty Should Be Repealed

Retirees drawing Social Security benefits are subject to an earnings test. For those ages 65 through 69, one dollar of benefits is withheld for every three dollars in wage income above $17,000 per year. For those ages 62 through 64, one dollar is withheld for every two dollars earned above $10,080.

"The earnings penalty reduces Social Security benefits by $1 for every $3 of wages."

The Social Security earnings test is among the most unfair and counterproductive policies ever imposed by the federal government. On the one hand, we are continually told that workers have a "right" to Social Security whenever there is a proposal to modify cost of living adjustments. But on the other hand, we take away benefits from many seniors simply because they have chosen to work past the normal retirement age. And historically it has been those most vocal about Social Security rights who have resisted most strenuously any elimination of the earnings test.[1]

This is a massive injustice. If people have in fact earned their Social Security benefits, then they are entitled to them. No one takes away someone's private pension or annuity if that person continues to work after becoming entitled to benefits. This disparate treatment makes a mockery of the notion that Social Security is an earned benefit that people are entitled to by virtue of long years of work. It makes Social Security equivalent to a welfare program where benefits are rightly withdrawn from people who no longer need them.

"Early retirees lose $1 of benefits for every $2 in wages."

A further element of unfairness results from the fact that the earnings test applies only to wage income. One can receive millions of dollars per year in interest, dividends and capital gains without losing a penny of Social Security benefits. But someone who has invested in human capital rather than financial capital is punished when he or she seeks a return on that investment by continuing to work.

Impact on the Labor Force. The earnings test was originally imposed for a reason that now makes no economic sense. Its purpose was to get workers out of the labor force during the Great Depression in order to open up jobs for younger workers.[2] Today, however, one of the biggest problems

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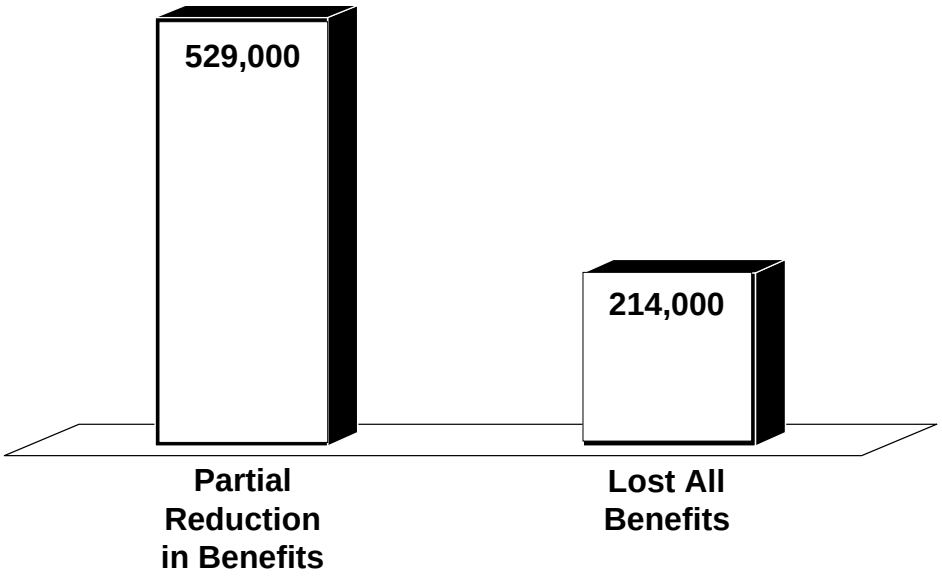
"In 1995, 743,000 workers had all or part of their benefits reduced."

FIGURE I

Workers Ages 65-70 Penalized for Exceeding Earnings Limit



Source: Social Security Administration.

facing the country is not a lack of jobs, but a lack of workers. The earnings test is not only depriving American businesses of labor they desperately need, but is keeping out of the labor force some of our best educated and most experienced workers.[3] As a nation we cannot afford to keep doing this.

Keeping older workers out of the labor force is also harmful to them. When they are forced into idleness by retirement, it often impacts negatively on their health and self-esteem.[4] And the notion that older workers are not healthy enough to continue working is simply no longer valid. Rising life expectancy and improved medicine mean that today's average 65-year-old is probably in better physical shape than a 40-year-old worker was before World War II.[5] Of course, no retiree should be forced to work if they prefer leisure, but actively penalizing those who want to work and are able to work is harmful both to them and the economy.

Loss of Benefits. According to the Social Security Administration, 3.5 million people between the ages of 62 and 69, about 37 percent of all retirees under the age of 70, have some earned income.[6] As Figure I shows:

- In 1995, 743,000 workers ages 65 to 70, or 8.5 percent of all retired worker beneficiaries, had their Social Security benefits reduced because their earnings exceeded the allowed amount.
- About 214,000 or 29 percent of those losing benefits received no Social Security benefits at all that year.

The total amount of benefits lost was $4.3 billion and the median benefits lost per recipient was $3,596.[7]

It should be noted that the earnings test also creates a kind of marriage penalty, because earnings by the primary Social Security recipient above the threshold can also reduce the benefits of auxiliary recipients. In 1995, secondary recipients losing benefits were primarily female. Only 2,000 males receiving secondary benefits lost benefits, while 62,000 females did.

"62,000 women lost benefits because a husband or parent exceeded the earnings limit."

Inclusion of secondary beneficiaries raises the number of those losing benefits in 1995 to 806,000. And because 154,000 other family members — nonworking spouses and children — are also affected by the reduction in benefits, the total number of people harmed by the earnings test rises to 960,000. But even this number understates the impact of the earnings test, because about 152,000 additional workers did not apply for benefits because their earnings were above the threshold.[8]

Tax Rates Punish the Elderly. The withholding of benefits acts like an additional tax on earnings.

- For retirees between the ages of 65 and 69 it is a 33 percent tax rate.
- For those between the ages of 62 and 64 it is a 50 percent tax rate.[9]

These implicit tax rates come on top of explicit taxes such as federal and state income taxes, including taxes on Social Security benefits for those whose incomes are high enough. Of course, older workers continue to pay Social Security taxes as well. For those in the 15 percent federal income tax bracket, even before state taxes this can raise the marginal tax rate as high as 63 percent for those ages 65-69 and 80 percent for those ages 62-64, as Figure II shows. The marginal tax rate is higher still for those in the 28 percent bracket, who may also be taxed on part of their Social Security benefits. One study found that the marginal tax bite, both explicit and implicit, can reach more than 100 percent in some cases.[10] Another study put the top rate at 96 percent just at the federal level.[11] And the incidence of high de facto marginal tax rates is not limited to just a few of the elderly. One study found that 30 percent of the single elderly and 12 percent of married elderly faced marginal tax rates exceeding 60 percent.[12]

These high effective tax rates have a major impact on the employment status of older workers. [See Figure III.]

- In 1999 only 16.9 percent of men over age 65 were in the labor force, either by working or seeking work.[13]
- Fifty years ago, 47 percent of such men were still in the labor force.
- At the turn of the century the figure was better than 60 percent.[14]

This sharp decline is all the more remarkable given the significant rise in life expectancy over this period.[15]

The Delayed Retirement Credit. The earnings test should be scrapped in its entirety. Either people have earned their benefits or they haven't, and singling out those who continue to work after retirement age is a violation of that principle. The only possible justification for keeping the earnings test is budgetary.[16] Obviously, elimination of the test would lead to the payment of benefits that are now not paid, increasing federal outlays for Social Security. However, this cost is often grossly overestimated because estimates do not take into account the impact of the delayed retirement credit (DRC).

The DRC raises benefits for retirees when they put off drawing Social Security benefits, even though they are eligible for them. Workers turning 65 this year will receive a 6 percent increase in their Social Security benefits for each year they delay drawing benefits. Thus, if their work history entitled them to $1,000 per month in benefits at age 65, but they did not begin drawing benefits until age 66, they would get $1,060 per month.[17]

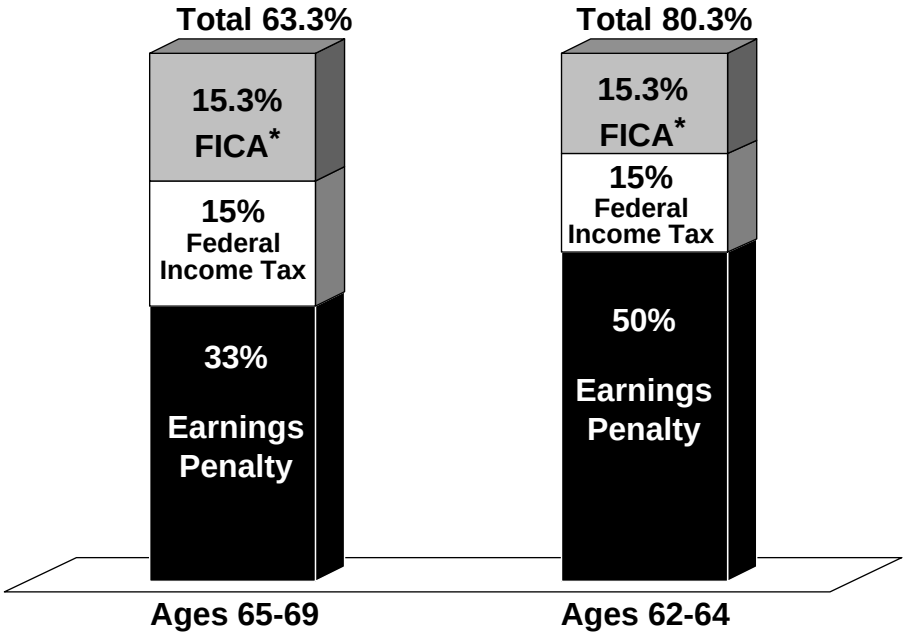
The idea of the credit is to encourage workers to stay in the labor force and not retire the minute they become eligible for benefits. But many workers

"Elderly workers in the 15 percent bracket can face a marginal tax rate as high as 80 percent."

FIGURE II

Marginal Tax Rates for Elderly Workers

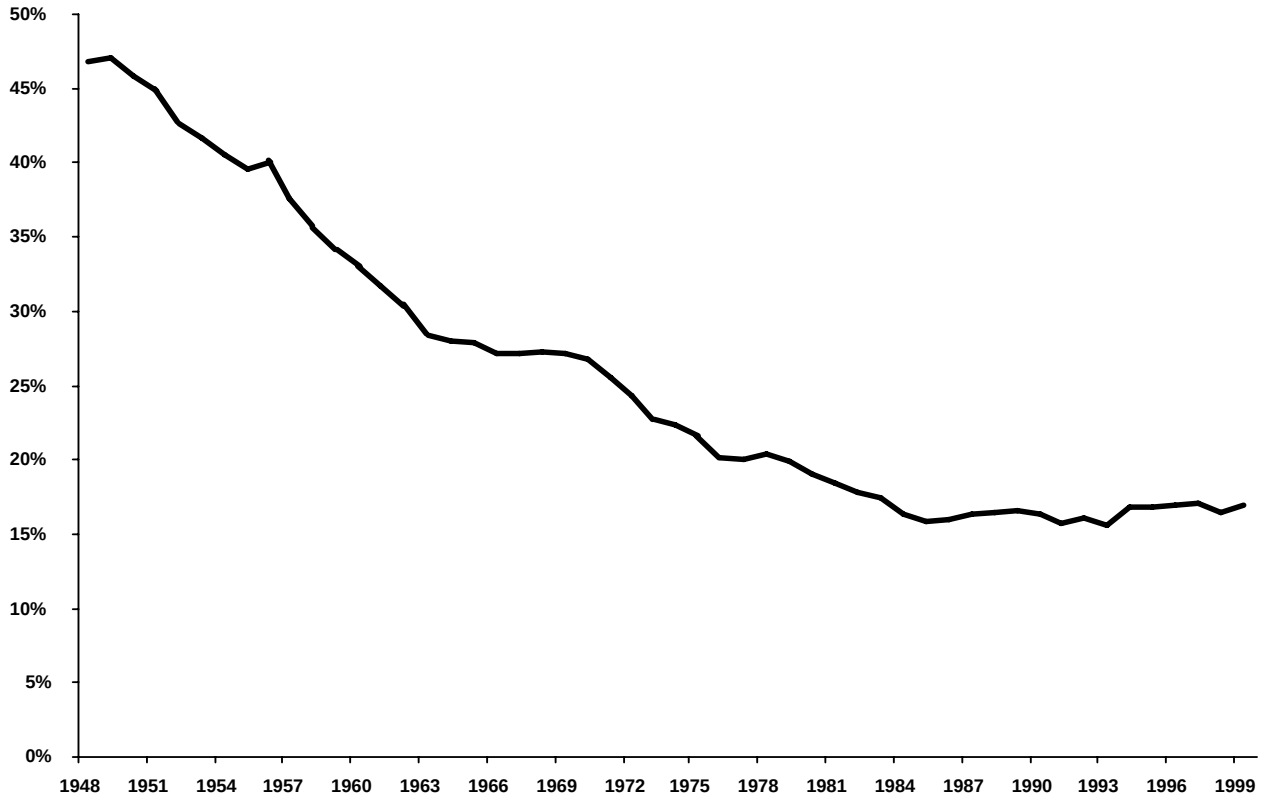
(15% federal income tax bracket)



* Includes employer share, which most economists agree is borne ultimately by the employee.

FIGURE III

Percent of Men Over Age 65 in the Labor Market, 1948-1999



Source: Bureau of Labor Statistics.

are under the mistaken belief that any benefits they fail to draw simply are lost. Hence, many workers are retiring too soon for their own good. A recent study from the National Bureau of Economic Research says that most workers would be better off by delaying their first Social Security benefit check by up to three years.[18]

"Participation of senior men in the labor force has dropped from 47 percent 50 years ago to less than 17 percent today."

In future years, the gain will increase. That is because the delayed retirement credit will rise to 8 percent in the year 2008 (for workers born in 1943).[19] This means that someone waiting until age 70 before drawing benefits would get 40 percent more than if they started at age 65. (After age 70 there is no further increase in benefits and also no earnings test.[20]) At that point, the Social Security actuaries estimate that the lifetime benefits people receive from Social Security will be about the same in the aggregate regardless of whether they retire at age 65 or age 70.

The DRC is extremely important in calculating the long term budgetary impact of eliminating the earnings test. Those people who now lose benefits because of the earnings test receive higher future benefits. They also receive higher benefits because earnings past age 65 can cause their benefits to be recomputed. That is because Social Security uses a 35-year earnings

history to calculate benefits. If post-65 annual earnings are greater than the lowest of these years, they can lead to higher benefits.

Because the DRC is supposed to cause lifetime benefits to be the same regardless of when people begin to draw benefits, the long term cost of eliminating the earnings test should in theory be zero. Higher benefits paid out in the short-run to people who would otherwise lose benefits because of the earnings test will be offset by lower future benefits because they will no longer claim the DRC.[21]

"There is no long-term cost to the government from eliminating the earnings test."

Another problem is that estimates of the net cost of eliminating the earnings test sometimes look only at increased payroll taxes that will result from expanded labor supply, as those now forced out of the labor market by the test remain in it or reenter.[22] These estimates tend to overlook higher income tax revenues and reduced outlays for Medicare due to older workers having employer-provided health benefits. One study that did take all of the relevant factors into account found that after about eight years, the net increase in federal outlays is just $1 billion per year.[23]

Conclusion. I believe that all arguments against abolishing the earnings limit are spurious. In fact, my suspicion is that the true barrier to doing so is simply class envy. Those who would benefit most in the short run from abolition of the earnings test are relatively high income earners. But in the longer run, especially given the rise in life expectancy, I would expect to see many more moderate income workers stay in the labor force if the earnings test were repealed.[24]

This is not a partisan issue. President Clinton proposed eliminating the earnings test in his State of the Union Address in 1999, and has reiterated his desire to do so again this year.[25]

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Senior Fellow

This Backgrounder is adapted from testimony before the Subcommittee on Social Security of the U.S. House Ways and Means Committee on February 15, 2000.

Notes

[1] For example, the *Washington Post* routinely decries any modification of the earnings test while strenuously defending a worker's right to benefits. See its editorials on March 15, 1996; December 3, 1995; January 17, 1995; January 17, 1991; December 2, 1989; and April 19, 1989.

[2] Marshall R. Colberg, *The Social Security Retirement Test: Right or Wrong?* (Washington: American Enterprise Institute, 1978), p. 2; C. Eugene Steuerle and Jon M. Bakija, *Retooling Social Security for the 21st Century* (Washington: Urban Institute Press, 1994), p. 226; and William Graebener, *A History of Retirement* (New Haven: Yale University Press, 1980), p. 186.

[3] See "Brain Drain," *Business Week,* September 20, 1999, pp. 112-126.

[4]See Committee for Economic Development, *New Opportunities for Older Workers* (1999), available at www.ced.org/pdf/OLDER.PDF.

[5] Eugene Steuerle, Christopher Spiro, and Richard W. Johnson, "Can Americans Work Longer?" *Straight Talk on Social Security and Retirement Policy* No. 5 (Washington: Urban Institute, 15 August 1999), available at www.urban.org/retirement/st/Straight5.pdf. A recent government report also suggests that estimates of rising life expectancy in the future may be understated. See Social Security Advisory Board, *The 1999 Technical Panel on Assumptions and Methods*, available at www.ssab.gov/reports.html.

[6] House Ways & Means Committee, *1998 Green Book* (Washington: U.S. Government Printing Office, 1998), p. 33.

[7] Bertram Kestenbaum, Michael Shakleford, and Chris Champlain, "Effect on Benefits of Earnings at Ages 65 or Older, 1995," *Social Security Bulletin*, Vol. 62, No. 1, 1999, pp. 4-9. For data on earlier years, see Joseph Bondar, "Beneficiaries Affected by the Annual Earnings Test, 1989," *Social Security Bulletin*, Vol. 56, No. 1, Spring 1993, pp. 20-28.

[8] Kestenbaum, Shakleford and Chaplain, op. cit.

[9] Policymakers often overlook the more punitive earnings test for those taking early retirement. See Eugene Steuerle and Christopher Spiro, "Are Policymakers Overlooking a Second Earnings Test?" *Straight Talk on Social Security and Retirement Policy* No. 9 (Washington: Urban Institute, 15 October 1999), available at www.urban.org/retirement/st/Straight9.pdf. The authors note that under current law, this more punitive earnings test will apply to more people as the normal retirement age is raised to 67. This will make workers between the ages of 65 and 66 subject to the high de facto tax rates that now apply only to those ages 62 to 64.

[10] See John Goodman, "Raising the Earnings Limit," National Center for Policy Analysis Brief Analysis No. 149, January 31, 1995, available at www.ncpa.org/ba/ba149.html.

[11] See Nathan Oestreich, Howard Toole, and Oliver Galbraith, "Restoring the Incentive for the Elderly to Work," *Tax Notes*, Vol. 49, No. 4, October 22, 1990, pp. 469-71.

[12] John R. Gist and Janemarie Mulvey, "Marginal Tax Rates and Older Workers," *Tax Notes*, Vol. 49, No. 6 November 5, 1990, pp. 679-94.

[13] Bureau of Labor Statistics data available at http://stats.bls.gov.

[14] Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970* (Washington: U.S. Government Printing Office, 1975), Part 1, p. 132. See also Roger L. Ransom and Richard Sutch, "The Labor of Older Americans: Retirement of Men On and Off the Job, 1870-1937," *Journal of Economic History*, Vol. 46, No. 1, March 1986, pp. 1-30.

[15] It is worth noting that when Social Security was first established, age 65 was greater than the male life expectancy at birth. See *Historical Statistics*, Part 1, p. 56.

[16] Historically, this has been the greatest political barrier to elimination of the earnings test despite broad bipartisan support for doing so. See Helen Dewar, "Senate Blocks Rise in Social Security Earning Limit," *Washington Post,* November 3, 1995; Kitty Dumas, "Budget-Buster Hot Potato: The Earnings Test," *Congressional Quarterly,* January 11, 1992, pp. 52-55; Julie Kosterlitz, "Working for a Price," *National Journal,* February 6, 1988, pp. 318-21.

[17] Actually, the DRC is calculated on a monthly basis, meaning that those who lose benefits because of the earnings test get some of it back.

[18] Courtney Coile et. al., "Delays in Claiming Social Security Benefits," National Bureau of Economic Research Working Paper No. 7318, August 1999, available at www.nber.org/papers/ w7318.

[19] The DRC was only 3 percent until 1989. Thus any studies based on this lower figure will grossly overestimate the budgetary cost of eliminating the earnings test, compared with a 6 percent or 8 percent rate.

[20] Note that in 2008, when the DRC is fully phased in, the age at which one may receive full benefits will be 66, and will continue rising to age 67 thereafter. This suggests a need to change the age at which the DRC is capped from age 70 to age 72, or else future workers will not get as much value from the DRC as current workers do.

[21] Jonathan Gruber and Peter Orszag, "What To Do About the Social Security Earnings Test?" Issue in Brief No. 1 (Boston: Center for Retirement Research, Boston College, July 1999), available at www.bc.edu/bc_org/aup/csom/executive/crr/ issuebriefs/ issuebrief1.pdf.

[22] Recent estimates of how much the labor supply would rise from elimination of the earnings test suggest that the magnitude could be fairly large. See Leora Friedberg, "The Labor Supply Effects of the Social Security Earnings Test," National Bureau of Economic Research Working Paper No. 7200, June 1999; idem, "The Social Security Earnings Test and Labor Supply of Older Men," in James M. Poterba, ed., *Tax Policy and the Economy*, Vol. 12 (Cambridge: MIT Press, 1998), pp. 121-50. Earlier studies generally found much lower labor responses. See Marjorie Honig and Cordelia Reimers, "Is It Worth Eliminating the Retirement Test?" *American Economic Review*, Vol. 79, No. 2 May 1989, pp. 103-107; Michael V. Leonesio, "The Effects of the Social Security Earnings Test on the Labor-Market Activity of Older Americans: A Review of the Evidence," *Social Security Bulletin*, Vol. 53, No. 5, May 1990, pp. 2-21; Michael D. Packard, "The Earnings Test and the Short-Run Work Response to Its Elimination," *Social Security Bulletin*, Vol. 53, No. 9, September 1990, pp. 3-16. Two early studies that did find a high labor response to reduction of the earnings penalty are Michael J. Boskin, "Social Security and Retirement Decisions," *Economic Inquiry*, Vol. 15, No. 1, January 1977, pp. 1-25; and Anthony J. Pellechio, "The Social Security Earnings Test, Labor Supply Distortions, and Foregone Payroll Tax Revenue," National Bureau of Economic Research Working Paper No. 272, August 1978.

[23] Gary Robbins and Aldona Robbins, "Retiring the Social Security Earnings Test," Institute for Policy Innovation Issue Brief, May 6, 1999, available at www.ipi.org. Another study found that the main long-run cost from eliminating the earnings test came from the recomputation of benefits. See Alan L. Gustman and Thomas L. Steinmeier, "Changing the Social Security Rules for Work After 65," *Industrial & Labor Relations Review*, Vol. 44, No. 4, July 1991, pp. 733-45. My guess is that most seniors would happily give up any recomputation of benefits for work after age 65 in return for abolition of the earnings test.

[24] Press reports indicate that many baby boomers don't wish to ever retire. See "So Who Wants to Retire?" *Business Week,* November 8, 1999, p. 8; Gene Epstein, "A Big New Wrinkle," *Barron's,* September 6, 1999, pp. 27-29; John Authers, "Boomers Want to Work Forever," *Financial Times,* October 30, 1998.

[25] The President said, "we should eliminate the limits on what seniors on Social Security can earn." *Congressional Record,* January 19, 1999, p. H259. In an interview with reporters on February 1, 2000, he said, "I think that something that costs money in the short run, but makes you money in the long run is lifting the earnings limits. And we plainly ought to do that." Accessed at www.nytimes.com/yr/mo/ day/news/financial/clinton-text.html on February 2, 2000. His latest comment came in an interview with CNN on February 14, 2000. He said, "I like getting rid of the earnings limitation. It's the right thing to do." John F. Harris and Juliet Eilperin, "Social Security Earnings Limit Targeted," *Washington Post*, February 15, 2000.

About the NCPA

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute founded in 1983 and funded exclusively by private contributions. The mission of the NCPA is to seek innovative private-sector solutions to public policy problems.

The center is probably best known for developing the concept of Medical Savings Accounts (MSAs). The *Wall Street Journal* called NCPA President John C. Goodman "the father of Medical Savings Accounts." Sen. Phil Gramm said MSAs are "the only original idea in health policy in more than a decade." Congress approved a pilot MSA program for small businesses and the self-employed in 1996 and voted in 1997 to allow Medicare beneficiaries to have MSAs.

Congress also relied on input from the NCPA in cutting the capital gains tax rate and in creating the Roth IRA. Both proposals were part of the pro-growth tax cuts agenda contained in the Contract with America and first proposed by the NCPA and the U.S. Chamber of Commerce in 1991. Two other recent tax changes — an increase in the estate tax exemption and abolition of the 15 percent tax penalty on excess withdrawals from pension accounts — also reflect NCPA proposals.

Another NCPA innovation is the concept of taxpayer choice — letting taxpayers rather than government decide where their welfare dollars go. Sen. Dan Coats and Rep. John Kasich have introduced a welfare reform bill incorporating the idea. It is also included in separate legislation sponsored by Rep. Jim Talent and Rep. J. C. Watts.

Entitlement reform is another important area. NCPA research shows that elderly entitlements will require taxes that take between one-half and two-thirds of workers' incomes by the time today's college students retire. A middle-income worker entering the labor market today can expect to pay almost $750,000 in taxes by the time he or she is 65 years of age, but will receive only $140,000 in benefits — assuming benefits are paid. At virtually every income level, Social Security makes people worse off — paying a lower rate of return than they could have earned in private capital markets. To solve this problem, the NCPA has developed a 12-step plan for Social Security privatization.

The NCPA has also developed ways of giving parents the opportunity to choose the best school for their children, whether public or private. For example, one NCPA study recommends a dollar-for-dollar tax credit up to $1,000 per child for money spent on tuition expenses at any qualified nongovernment school — a form of taxpayer choice for education.

The NCPA's Environmental Center works closely with other think tanks to provide common sense alternatives to extreme positions that frequently dominate environmental policy debates. In 1991 the NCPA organized a 76-member task force, representing 64 think tanks and research institutes, to produce *Progressive Environmentalism*, a pro-free enterprise, pro-science, pro-human report on environmental issues. The task force concluded that empowering individuals rather than government bureaucracies offers the greatest promise for a cleaner environment. More recently, the NCPA produced *New Environmentalism*, written by Reason Foundation scholar Lynn Scarlett. The study proposes a framework for making the nation's environmental efforts more effective while reducing regulatory burdens.

In 1990 the NCPA's Center for Health Policy Studies created a health care task force with representatives from 40 think tanks and research institutes. The pro-free enterprise policy proposals developed

by the task force became the basis for a 1992 book, *Patient Power*, by John Goodman and Gerald Musgrave. More than 300,000 copies of the book were printed and distributed by the Cato Institute, and many credit it as becoming the focal point of opposition to Hillary Clinton's health care reform plan.

A number of bills before Congress promise to protect patients from abuses by HMOs and other managed care plans. Although these bills are portrayed as consumer protection measures, NCPA studies show they would make insurance more costly and increase the number of uninsured Americans. An NCPA proposal to solve the problem of the growing number of Americans without health insurance would provide refundable tax credits for those who purchase their own health insurance.

NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA experts appear regularly in national publications such as the *Wall Street Journal, Washington Times* and *Investor's Business Daily*. NCPA Policy Chairman Pete du Pont's radio commentaries are carried on 359 radio stations across America. The NCPA regularly sponsors and participates in *Firing Line Debate*, which is aired on 302 public broadcasting stations. The NCPA each year sponsors 22 one-hour televised debates on the PBS program *DebatesDebates,* seen in more than 170 markets.

According to Burrelle's, the NCPA reached the average household 10 times in 1998. More than 36,000 column inches devoted to NCPA ideas appeared in newspapers and magazines in 1997. The advertising value of this print and broadcast coverage was more than $56 million, even though the NCPA budget for 1998 was only $4 million.

The NCPA has one of the most extensive Internet sites for pro-free enterprise approaches to public policy issues, receiving about one million hits (page views) per month. All NCPA publications are available online, and the website provides numerous links to other sites containing related information. The NCPA also produces an online journal, *Daily Policy Digest,* which summarizes public policy research findings each business day and is available by e-mail to anyone who requests it.

What Others Say about the NCPA

"...influencing the national debate with studies, reports and seminars."

— TIME

"...steadily thrusting such ideas as 'privatization' of social services into the intellectual marketplace."

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